

DOCUMENT RESUME

04399 - [B3324553]

[Pricing of Modification to Air Force Contract with the Boeing Company]. PSAD-78-42; B-168450. November 25, 1977. 3 pp. + enclosure (19 pp.).

Report to Secretary, Department of Defense; by Jerome H. Stolarow (for Richard W. Gutmann, Director, Procurement and Systems Acquisition Div.).

Issue Area: Federal Procurement of Goods and Services: Reasonableness of Prices Under Negotiated Contracts and Subcontracts (1904).

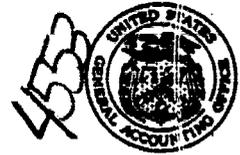
Contact: Procurement and Systems Acquisition Div.

Budget Function: National Defense; Department of Defense - Procurement & Contracts (058).

Organization Concerned: Department of the Air Force: Electronic Systems Div., Hanscom AFB, MA; Boeing Co., Seattle, WA; Cost Accounting Standards Board.

Authority: P.L. 87-653.

Modification P00450, awarded by the Air Force's Electronic Systems Division, is a fixed-price-incentive successive target contract for the first production buy of Airborne Warning and Control Systems and provides for the production of six systems and related training equipment, aerospace ground equipment, and data at a target price of \$293,300,000. Findings/Conclusions: The initial target cost of the modification was overstated by about \$2.4 million because certain cost or pricing data the contractor provided the Air Force in support of proposed costs were not accurate, complete, and current. The overstatement will result in an estimated \$508,000 of excess cost to the Government. Also, the initial target cost may require a reduction of about \$1.7 million because of the deferral and cancellation of the procurement of certain aerospace ground equipment and related data. The Cost Accounting Standards (CAS) Board agreed that the modification contract should have included the standard CAS clause which would have required the contractor to follow certain uniform costing accounting practices. Because this clause was omitted, \$1.3 million of potentially unallowable property tax cost was not questioned during preaward audits of the contractor's proposal. Recommendations: The Electronic Systems Division should consider the information presented in this examination and any additional information available to determine whether the Government is entitled to a price adjustment under modification P00450. (Author/HTW)



UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

PROCUREMENT AND SYSTEMS
ACQUISITION DIVISION

25 NOV 1977

04399
B-16845/1

The Honorable
The Secretary of Defense

Attention: Assistant Secretary of Defense
(Comptroller)

Dear Mr. Secretary:

We have examined the pricing of modification P00450 to Air Force contract F19628-70-C-0218 with The Boeing Company, Seattle, Washington. Modification P00450 is a Fixed-Price-Incentive Successive Target contract for the first production buy of Airborne Warning and Control Systems (AWACS). The modification, awarded by the Air Force's Electronic Systems Division, provides for the production of six systems and related training equipment, aerospace ground equipment, and data at a target price of \$293,300,000.

This examination was part of our nationwide review of the pricing of Department of Defense negotiated non-competitive prime contracts. Individual contract reviews represent part of our efforts to monitor the Department's adherence to prescribed laws, regulations, and procedures in negotiating noncompetitive contract prices. Our objectives were to determine if the (1) price of the modification was reasonable based on cost or pricing data available to the contractor at the time of negotiations and (2) contract modification should have been subject to cost accounting standards (CAS) requirements.

We estimate that the initial target cost of the modification was overstated by about \$2.4 million because certain cost or pricing data the contractor provided the Air Force in support of proposed costs was not accurate, complete, and current. We estimate that the overstatement of the target cost will result in approximately \$508,000 of excess cost to the Government. In addition, the initial

PSAD-78-42
(950385)

target cost may require a reduction of about \$1.7 million because of the deferral and cancellation of the procurement of certain aerospace ground equipment and related data.

We also believe, and the Cost Accounting Standards Board agrees, that the modification contract should have included the standard CAS clause which would have required the contractor to follow certain uniform cost accounting practices. Because the CAS clause was omitted, \$1.3 million of potentially unallowable property tax cost was not questioned during preaward audits of the contractor's proposal. Details of our review are provided in the enclosure.

Contractor and agency comments

Boeing advised us that data used to support modification P00450 was accurate, current, and complete and that no basis for a reduction of the contract price exists. Boeing officials, however, did not provide adequate explanations of the nondisclosure of the data discussed in this report or why it should not have been considered in establishing a price for this modification.

The Electronic Systems Division was in general agreement with the facts concerning potential overpricing. On whether the CAS clause should have been included in the contract, the Electronic Systems Division told us that the primary reason for not including CAS provisions in the contract was the potential impacts on contract cost. We believe, however, that since the CAS clause was required to be included by CAS regulations, the cost impact was not a matter for consideration.

Recommendations

We recommend that you have the Electronic Systems Division consider the information presented herein, along with any additional information available, to determine whether the Government is entitled to a price adjustment under modification P00450.

In regard to the omission of the CAS clause from this modification, we are not making a recommendation because interim guidance on the application of the CAS clause to contract modifications has been incorporated into the Armed Services Procurement Regulation.

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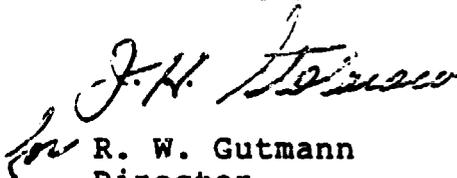
We are sending copies of this letter to The Boeing Company; the Director, Office of Management and Budget;

the Secretary of the Air Force; the Commander, Electronic Systems Division, Air Force Systems Command; the Director, Defense Contract Audit Agency; and the Chairman, Renegotiation Board. We are also sending copies to the Chairmen, House and Senate Committees on Appropriations and Armed Services, the House Committee on Government Operations; and the Senate Committee on Governmental Affairs.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We would appreciate receiving your comments on the matters discussed in this report and would be happy to discuss any questions that you may have.

Sincerely yours,


R. W. Gutmann
Director

Enclosure

REVIEW OF TARGET PRICING OF
MODIFICATION P00450 TO AIR FORCE
CONTRACT F19628-70-C-0218 WITH
THE BOEING COMPANY

BACKGROUND

Modification P00450, awarded by the Air Force's Electronic Systems Division (ESD), was established as a Fixed Price Incentive Successive Targets (FPIS) type of contract. The initial target price was negotiated on September 9, 1975. This target is scheduled to be reset in calendar year 1977. Boeing receives an initial target profit of 10.68 percent (shown as 10.7 percent in contract) and may share in cost overruns or underruns. If the firm target cost is more than the initial target cost by more than \$15 million, the initial target profit will be decreased by 10 percent of the difference between the initial target cost plus \$15 million and the firm target cost. If the firm target cost is less than the initial target cost, the initial target profit will be increased by 20 percent of the difference between the initial target cost and the firm target cost. Also, there is a maximum firm target profit of 12.5 percent of the initial target cost and a minimum of 0 percent.

Public Law 87-653 requires prime contractors to submit cost or pricing data in support of proposed prices for noncompetitive contracts expected to exceed \$100,000 and to certify that this data is accurate, complete, and current. Contract prices can be adjusted when the price to the

Government has been increased significantly because the contractor furnished data that was inaccurate, incomplete, or noncurrent as of the effective date of the certificate.

The modification was negotiated based on Boeing's cost proposal of August 29, 1975, for \$328.792 million. The cost or pricing data submitted was certified to be accurate, current, and complete as of September 9, 1975. There was a lump sum settlement of \$265 million on September 9, 1975. The Air Force and Boeing did not allocate the difference to cost elements. The negotiated target price for modification P00450 was as follows:

Initial target cost	\$265,000,000
Initial target profit	28,300,000
Initial target price	293,300,000
Initial ceiling price	344,500,000

At the time of our review, with 75 percent of estimated final costs incurred, Boeing was projecting an initial target cost overrun of about \$25 million.

OVERPRICING

In our review we examined estimated prime contract target costs for subcontracts with Westinghouse Electric Corporation, International Business Machines Corporation (IBM), and the Hazeltine Corporation, and a purchase order issued to Hughes Aircraft Company.

We estimate that the initial target cost for modification P00450 was overstated by about \$2.4 million because certain

cost or pricing data the contractor provided to the Air Force in support of initial target cost proposals was not accurate, complete, and current. Unless the contract price is adjusted, we estimate that this overstatement will result in excess costs to the Government of about \$508,000.

The following table shows the overstated costs included in the negotiated initial target cost, and our computation of excess costs to the government.

<u>Cost element</u>	<u>Amount</u>		
	<u>Overstatement in Boeing proposal of 8/29/75</u>	<u>Negotiated a/reductions</u>	<u>Net overstatement</u>
Westinghouse--change in delivery schedule	\$1,767,000	\$1,010,000	\$ 757,000
IBM:			
Price adjustment clause	608,000	63,797	544,203
Data	345,446	33,957	311,489
Technical support	114,821	11,287	103,534
Technical orders and manuals	<u>95,540</u>	<u>9,392</u>	<u>06,148</u>
Total	1,163,807	118,433	1,045,374
Hazeltine--data	840,000	500,000	340,000
Hughes--data and equipment	<u>180,679</u>	<u>15,770</u>	<u>164,909</u>
Totals	<u>\$3,951,486</u>	<u>\$1,644,203</u>	<u>\$2,307,283</u>

Indirect costs

Subcontract costs:

Spares and allowance for changes: 4.35% b/ of \$2,142,374 93,193

Direct charges and GSA expense on direct charges: 2.05% b/ of (\$2,142,374 + \$93,193) 45,829

Purchase equipment:

Spares and allowance for changes: 5.35% b/ of \$164,909 8,823

Direct charges and GSA expense on direct charges: 2.05% b/ of \$164,909 + 8,823) 3,562

Total overstated initial target cost \$2,458,690

Excess cost to the Government

Target profit: 10.68% of 2,458,690 \$262,588

Incentive profit: 10% of 2,458,690 c/ 245,869

Total excess cost to the Government \$508,457

a/ The computations were developed from Boeing and Air Force data.

b/ Air Force opinion of rates negotiated.

c/ This computation assumes that the negotiated firm target cost will exceed the initial target cost by more than \$15 million as indicated by a recent Boeing estimate (see page 1).

Westinghouse Cost Element

Westinghouse is the supplier of surveillance radar. Boeing's final target cost proposal was segregated into cost elements which had been negotiated and elements which were to be negotiated.

Included in Boeing's proposal were estimated costs of \$6,416,000 to be negotiated with Westinghouse for a change in the scheduled delivery rate of the surveillance radar. On August 28, 1975, Boeing negotiated a price of \$4,704,000 for this schedule revision, or \$1,712,000 less than the \$6,416,000 included in its final target cost proposal. In addition, Westinghouse advised Boeing that Westinghouse would reduce certain labor adjustment factors for 1975, but the amount of the reduction was unknown at that time. Boeing estimated that this adjustment would decrease the schedule revision settlement with Westinghouse to \$4,649,000. Accordingly, estimated costs included in Boeing's proposal for the schedule revision exceeded latest available data by \$1,767,000 ($\$6,416,000 - \$4,649,000$).

Boeing officials told us that this data on the price settlement with Westinghouse was provided to the Air Force contracting officer in Handout 51.

Handout 51, a 17-page document, contains a stamp, signed by Boeings chief negotiator, showing that it was given to the contracting officer on September 16, 1975. However, Boeing told us that two pages of this handout were initially submitted to the Government on September 9, 1975, prior to agreement and

certification. Boeing further stated that at that time the Air Force (Price Analyst) requested additional backup data to the summaries. Accordingly, backup detail was provided in the September 16, 1975, document.

The contractor provided no documentation showing that the two pertinent pages were given to the Air Force price analyst on September 9, 1975. We found no record of this document in the Air Force contract files, and Air Force officials at ESD told us that they had no knowledge of having received the summary prior to the completion of negotiations. Further, the Air Force price negotiation memorandum does not show that this document was considered in the final target price negotiations. We, therefore, believe that the cost proposed by Boeing for the subcontract item was overstated by \$1,767,000.

IBM Cost Elements

Price adjustment clause

Agreement was reached between Boeing and IBM on September 4, 1975, to eliminate Special Clause 1 (contract price adjustment for possible fluctuations in the economy). They agreed to a price of \$41,000 or \$608,000 less than the estimate of \$649,000 included in Boeing's final target cost proposal to the Air Force.

Data

IBM submitted a price proposal to Boeing dated August 27, 1975, which reduced the subcontractor's total proposal price for data to \$1,013,554 or \$345,446 less than the estimate of

\$1,359,000 included in the contractor's final target cost proposal to the Air Force.

Technical support

Boeing included an estimate of \$395,000 for IBM technical support based on an IBM program office estimate. This was for 42 man-months at about \$9,399 per month.

The GAO estimate for the technical support function is \$280,179 (\$114,821 decrease). Our estimate was based on current information supplied by the IBM finance office prior to contract negotiations of approximately \$6,571 per man-month. This included a \$6,398 cost per man-month plus annual wage rate increases based on IBM proposal data.

Technical orders and manuals

Boeing's final target cost proposal included \$1,546,000 for technical orders and manuals to be supplied by IBM. This proposal was based on an IBM price proposal dated August 15, 1975. We found, however, that, as a result of a Boeing audit which disclosed a duplication in IBM's proposal, IBM reduced its proposed price by \$95,540. Since Boeing's proposal of \$1,546,000 was based on data that was inaccurate, the cost proposed for technical orders and manuals was overstated by \$95,540.

Hazeltine Cost Element

Hazeltine is the supplier of data display and control functional group equipment. Boeing's final target cost proposal for the Hazeltine subcontract included \$1 million for data. On October 9, 1975, 1 month after the prime contract target price was agreed on, Hazeltine proposed \$104,819 as a price for the data.

Boeing officials told us that no support was provided for the \$1 million estimate and that the amount was presented as a Boeing material estimate. They said that this estimate for Hazeltine was based on an IBM price proposal of \$1,359,000 for data because of the similarity of Hazeltine and IBM contract requirements.

Data to be developed by IBM was significantly greater than that for Hazeltine because of the requirements under SD-E-109-3, paragraph 1f (item 1 below).

IBM's proposal, as adjusted to August 27, 1975, was for the following data items.

1. SD-E-109-3 - Engineering Data for as Designed Baseline, paragraph 1f. This requirement was for preparing and submitting performance specifications.	\$854,047
2. Remainder of SD-E-109-3 requirements (Engineering drawings, diagrams, parts lists, material specs, etc.)	119,632
3. All other data items	<u>39,875</u>
	<u>\$1,013,554</u>

Our review at the Hazeltine Corporation indicated that Hazeltine's proposed costs were not for item 1 as in the IBM proposal. They were for providing microfilm of drawings previously developed by Hazeltine and its parts suppliers and for items 2 and 3 as stated in the IBM proposal. Further, the data supporting the cost to perform the requirements of the Hazeltine contract were available by August 1975. This data

showed that the requirements of the Hazeltine contract could be performed at a cost of about \$105,000 including profit or for about \$895,000 less than the \$1,000,000 proposed by Boeing. However, had Boeing used the IBM proposal as a basis for proposing a cost for the Hazeltine subcontract, the IBM proposed price of \$1,013,554 should have been reduced by \$854,047, (the cost of the SD-E-109-3, paragraph 1f, requirement) to \$159,507. Therefore, the price proposed by Boeing for the Hazeltine contract was overstated by \$840,493, \$1,000,000 minus \$159,507.

Hughes Cost Elements

Hughes Aircraft Company is the supplier of the audio distribution system. Estimated costs included in Boeing's target cost proposal to the Air Force of August 29, 1975, for data to be provided by Hughes were overstated by about \$196,636, however, this amount is reduced to \$180,079 because certain costs in Boeing's proposal were excluded.

The overpricing occurred because, prior to the completion of target price negotiations, certain data items which were canceled, replaced, or transferred for purchase under another prime contract, were included in Boeing's proposal.

Data items canceled, replaced, transferred, or added

A March 7, 1975, Hughes letter to Boeing transmitted a proposal for the audio distribution system at a price of \$5,678,397 which included data and technical order requirements.

On two occasions, April 11, 1975, and May 1, 1975, Boeing changed the data requirements from those shown in Hughes' March 7, 1975, proposal. These changes reduced Hughes' proposal price by about \$142,745, but Boeing only reduced its proposal by \$17,799. The remaining reduction of \$124,946 was not recognized in Boeing's proposal to the Air Force.

On August 21, 1975, Boeing increased its proposal to add a replacement data item but did not reduce the proposal for the value of the item replaced. The obsolete data item was included in the March 7, 1975, Hughes proposal and in Boeing's final target cost proposal at \$10,037. Hughes' March 7, 1975, proposal also included \$61,653 for spares, however, prior to the prime contract negotiation, a decision was made by Boeing to purchase these spares under a separate contract. As Boeing did not recognize this decision in its target-cost proposal of August 29, 1975, the proposal was overstated by \$61,653.

Additional mission simulator equipment purchased on March 12, 1975, as item 2 of Boeing's subcontract with Hughes, A-889209-7070, change 1, for \$15,957 was not included in Boeing's initial target cost proposal of August 29, 1975. The contractor advised us that this additional equipment should have been included in the proposal because engineering change proposal (ECP) 164R which authorized the equipment was included in the contract change proposal (CCP) 0250.

Boeing AWACS engineering change memo dated February 10, 1975, discusses CCP-0250 preparation and pricing. This memo shows that ECP 164R was included for production.

We found that a purchase requisition dated January 9, 1975, for additional mission simulator equipment was issued in accordance with ECP 164. Therefore, the \$15,957 of cost should have been included in the Hughes subcontract cost.

Conclusion and recommendation

Unless the price of the contract modification is reduced to adjust for the overstatement described in this report, the Government will incur excess costs of about \$508,457. Accordingly, we recommend that ESD take appropriate action to adjust the contract price.

OTHER ISSUES

Automatic Test Equipment and Related Data

Boeing's April 7, 1975, audit/analysis report states that Hughes' proposal costs for depot aerospace ground equipment (AGE) and data item UT-01-MCM, test requirements documents, were being deferred and that the costs as quoted were deleted in Boeing's analysis.

Boeing's April 11, 1975, letter to Hughes stated that data item UT-01-MCM was deferred. This item was priced at \$932,555 in Hughes' March 7, 1975, proposal and in Boeing's final proposal to the Air Force. Boeing advised us that the decision to defer this data item was based on an internal Boeing recommendation to

delay until such time as AGE requirements were more definitive. Boeing also stated that the Air Force was not formally advised that this data item was deferred.

Boeing advised us that this data item was deferred from the Hughes subcontract because the automatic test equipment was not sufficiently defined. This specifically included the audio distribution system test set, which is organizational and intermediate AGE. Boeing also said that this data item was required for the audio distribution system test set.

Boeing's initial target price proposal included an estimated cost of \$1.322 million for one audio distribution system test set. Subsequent to prime contract negotiations, the Air Force disapproved development of the audio distribution system test equipment. Accordingly, there was no need for data for this test set.

A test station was purchased from Hughes at a cost of \$320,000 and, in March 1977, Boeing proposed that a test station be provided in place of the audio distribution system test set and that test requirement documentation not be provided for the test station. Substitution of the test station for the audio distribution system test set appears to be a change requiring adjustment of the prime contract initial target price since this change would require a waiver of requirements.

Boeing provided several reasons why data item UT-01-MCM was included in the prime contract's initial target price. We were unable to substantiate the validity of the issues raised because of the lack of complete documentation and the

status of the procurement of organizational and intermediate AGE. However, our review indicates that the initial target direct costs may be excessive by as much as \$1.732 million as shown below. These costs are not included in our computations on page 4 which show excess costs to the Government.

	<u>Amount</u>
	(000 omitted)
Deletion of ADS Test Set requirement (\$1,322,000 less 9.66% <u>a/</u> negotiation reduction)	\$1,194
Deletion of data for ADS Test Set (\$932,555 less 8.02% negotiation reduction)	<u>858</u>
	\$2,052
Addition of Test Station <u>b/</u>	<u>(320)</u>
Net reduction	<u>\$1,732</u>

a/ Estimated reduction for proposed costs not firmly priced of \$5,175,000 was \$500,000.

b/ This reduction assumes that the Air Force will approve the Test Station.

We recommend that this area be examined by ESD and the contract price be adjusted if warranted.

Cost Accounting Standards

Modification P00450 to the contract did not include the required cost accounting standards' (CAS) clause.

CAS rules and regulations promulgated by the Cost Accounting Standards Board carry the full force and effect of law. They are binding on all Federal agencies making national defense procurements.

Procurement agencies within the Department of Defense are responsible for securing contractor compliance with the Cost Accounting Standards Board's requirements. This responsibility includes incorporating a prescribed CAS contract clause in all covered contracts.

The CAS contract clause was not included in the basic AWACS contract or modification P00450 to this contract. Because the basic contract was issued before the effective date of CAS, it appropriately did not include the clause. Modification P00450, however, was negotiated in September 1975 after the effective date of CAS.

The Defense Contract Audit Agency, in its preaward audit report on evaluation of the contractor's price proposal for modification P00450 (Report No. 7381-04-6-0058 dated August 5, 1975), concluded that the modification was subject to CAS requirements and recommended that CAS provisions be incorporated into the contract. The DCAA report provided the following rationale for its conclusion.

"With respect to contract modifications the CAS Board stated in the prefatory comments (See volume 37, pages 4140 and 4141, Paragraph 6 of the Federal Register of February 29, 1972) that it had addressed the question and for the time being rejected the application of CAS to contract changes except for renewals of annual contracts and similar changes for new work. Their reason for doing so was based on the inability of most contractors to segregate cost of changes from other work."

The DCAA report concluded that the modification was for new work. The report said that while the basic contract provisions included options for additional AWACS aircraft, the Government

did not exercise these options and they were allowed to expire. DCAA also said that the contractor intends to segregate the costs applicable to the modification.

In view of the foregoing circumstances, we asked the ESD for the rationale they used to conclude that modification P00450 should not be subject to the standards. ESD said that the primary reason for not including CAS provisions in the contract was the cost and other impacts associated with changing this contract from "uncovered" to "covered" during the negotiation of modification P00450. The letter said that "the contractor estimated an additional cost impact of at least \$3 million, associated with changing accounting procedures and reopening of previously negotiated subcontracts to flow CAS requirements to subcontracts." However, we were told by the Air Force contracting officer that the contractor did not provide any backup documentation to support this alleged cost impact. Since the Boeing Aerospace Company 1/ accounting system was already under CAS requirements, we doubt whether there would have been a significant cost impact to change accounting procedures for this contract. Further, we believe that most, if not all, of Boeing's subcontractors were also required to follow the standards.

1/The division within the Boeing Company responsible for this contract.

ESD also stated that there was no requirement for the inclusion of CAS in the contract, citing an Air Force Systems Command letter dated September 26, 1973. This letter stated as criteria the following:

"AFSC's position is that once a contract has been determined not to be covered, future negotiated changes in excess of \$100,000 will not make it a covered contract. DOD has informally indicated their approval of this position provided that the change did not add new work or quantities which would, in effect, make it a new contract."

We asked the CAS Board, by letter dated March 11, 1977, whether they agreed with our conclusion that the CAS provisions should have been incorporated into the contract for the initial production buy. The CAS Board concurred that the CAS provisions should have been incorporated into the contract for the initial production buy under modification P00450 for the following reasons:

1. Paragraph 6 of Appendix A in the Board's regulations states that the Board intends that the annual extension of existing negotiated contracts and similar contract modifications would not be exempt from the Board's rules, regulations, and cost accounting standards. Modification P00450 definitized the separate procurement of six systems which was similar to an annual extension of an existing negotiated contract.
2. Modification P00450 was not for an "instead of" type change which, the Board indicated in the aforementioned paragraph 6, should be exempt from the standards where

the cost/price adjustment would only be for the incremental effect of the change and it would be difficult to separately identify the incremental costs.

3. The prices negotiated for the six units resulted from a new proposal being submitted, evaluated, and negotiated.
4. The specific quantity of units purchased (6) under modification P00450 for the initial production was not contemplated under the options contained in the basic contract. Hence, P00450 was a new procurement and should have had the required terms and conditions of a new contract.

We provided the CAS Board with (1) summary data on pertinent contract option provisions from the original contract award through modification P00450; (2) our letter to ESD; (3) ESD's letter response; (4) excerpts from the DCAA report; (5) Office of Assistant Secretary of Defense (OASD) letter dated March 18, 1976, transmitting OASD, CAS Working Group Interim Guidance dated February 24, 1976; (6) the options section of the basic contract; and (7) the Air Force Systems Command's guidance dated September 26, 1973.

The CAS Board advised us by letter dated March 28, 1977, that the CAS provisions should have been incorporated in the modification. They commented, in part, as follows:

"The original AWACS contract contains several provisions characterized as options. Modification P00450, however, was not made pursuant to any of those provisions. Therefore, the question of whether this modification represented the exercise of a bona fide option does not appear to be

involved. Instead, the modification appears to be similar to an annual contract extension which the Board believes should be subject to its Standards, rules, and regulations.

"Were the option question to arise, it would be necessary to look beyond the label and examine the nature of the transaction. Many so-called options would, in our view, constitute contract modifications of the type which should be deemed to require application of the CAS clause even though the clause was not included in the basic contract. Among these are provisions characterized as options which declare, in essence, that the Government has a right to order additional quantities under a contract, and if it exercises that right, the parties will negotiate the terms and conditions which shall govern the delivery and price of the additional quantities. We would not regard a provision of this type as an option or as any other kind of contractual commitment that would justify the failure to include the CAS clause in the contract modification. Consequently, when the parties negotiate the terms and conditions for the additional quantities, CAS clause applicability must be determined as it would be determined for a new procurement."

DCAA reported that "the contractor has made several voluntary accounting changes that have affected the amount of adjustment of F0218 [contract] for the effect of the changes."

Also, DCAA reported that the Boeing price proposal for the modification included \$1.3 million of potentially unallowable property taxes which they did not question in the absence of the CAS clause. This issue involved the method of allocating taxes to U.S. Government contracts and to non-Government contracts. The case was eventually determined in favor of the Government by the Armed Services Board of Contract Appeals; however, the contractor can allocate and the Government will pay for these costs applicable to modification P00450 because the CAS clause was not included in the contract modification.

These cost savings may have been offset to some extent by additional costs to implement CAS. However, cost was not

the governing guideline in this instance--CAS provisions were required to be included in the contract modification.

Apparently in recognition of this problem, Defense Procurement Circular 76-11, dated September 30, 1977, was issued to provide interim guidance on the application of CAS requirements to contract modifications. We believe this interim guidance will help prevent unwarranted omissions of the CAS clause.

Conclusion

In our opinion, the Air Force did not take adequate action to include cost accounting standards in the provisions of modification P00450 to the contract. Since the contract modification of \$293,300,000 was not made pursuant to existing contract provisions, we believe it was "new work" and apparently was similar to an annual contract extension.

ESD has stated that the primary reason the CAS clause was not included in this contract modification was the cost impact associated with complying with CAS. We believe, however, that since the CAS clause was required by CAS Board regulations, the cost impact was not a matter for consideration.